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LESSONS LEARNED ON EQUITY COMPENSATION

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This is the ninth year that we have hosted at least one major conference on employee ownership or equity sharing. In this conference, we will endeavor to show how you can use equity compensation in building a high-performance company.

Many of you are probably wondering, "After eight years, what can you possibly talk about that would be new?"

Speaking as someone who has been experimenting with, practicing and learning about equity compensation for over 26 years, the answer is that every year I have learned something new about equity sharing. I have had three test beds to observe equity sharing — the Foundation, SAIC's experience and what has been happening in the rest of the world.

This morning I want to share with you some of our lessons learned.

1987

Our first conference in 1987 was held at a time when American capitalism was in question. The Japanese in particular were demonstrating a superior ability to compete in world markets. We believed equity sharing would be a way to increase U.S. competitiveness. We invited Ira Magaziner, who was chairing a commission studying the issue, to speak at our conference. To our surprise, he refused. He told us we were on the "wrong track."

In 1987 we believed we could reform the world. In hindsight, we were terrifically naive. I thought all we had to do was show people what we were doing at SAIC and there would be a mad rush to set up employee ownership programs like ours. However, I learned that every person and company reacts differently to these ideas. Over time, we've learned that many forms of equity sharing would be needed, and that most can and do help.

Another major lesson learned from our first conference was that there is more than one reason to share equity. For me, the primary driver has always been the morally right argument — rewarding employees who build the company is the fair way to operate. We also know that equity ownership motivates and rewards employees; increases productivity, competitiveness and profitability; helps you recruit and retain your top performers; and aligns employee and management goals with those of the company and other shareholders.

In a wrap-up meeting, we were encouraged to focus the Foundation's energies on helping individual companies rather than taking on the whole world. We decided to make advisory services to companies a priority.

1988

In 1988 we lost more of our innocence. Not only did we recognize that there needed to be more than one approach to equity sharing, but we began to understand that the concept needed new methods of promotion. There were few examples of success that weren't ESOPs. There was little momentum in society or among economic institutions for more employee participation in the ownership of companies. While we believed firmly in what we were doing, we began to feel a little like the early Christians, the "voices crying in the wilderness."

We also heard from a number of sources at our 1988 conference that equity sharing in some form was inevitable in the highly competitive global economy. Jim Pinto of Action Instruments told us that, "The salvation of capitalism is employee ownership." While that may seem to be an extreme proposition, Professor Joseph Blasi of Rutgers University saw the problem and the solution in much the same way. He said, "In a global competitive situation, we are going to move to a flexible compensation system — a fair fixed wage, an employee ownership component, and a profit-sharing or bonus component." I think the prediction of these speakers is coming true. More and more companies are shifting to compensation systems that share the pie and share the risk through ownership opportunities, including stock and option awards.

1989

In 1989 we focused on productivity and competitiveness. We heard the experiences of a number of companies that were encountering hurdles in their efforts to broaden employee ownership.

We heard that you can't go headlong into employee ownership at the beginning. Companies were telling us the concept was sound, but they had learned to be sparing in giving stock to key employees during the start-up phases.

As Harry Casari, an advisor to entrepreneurial companies, told us, "If you give your accounting manager 1% of the company as an option early on, what are you going to give the CFO two years later?" You have to have stock available to reward other employees as the company grows.

We also learned that capital-intensive companies have special needs that make employee-ownership more difficult. Myron Eichen of Brooktree Corporation said, "If I knew some way to take a capital-intensive company and make it 100% employee-owned, I would do everything in my power to cause that to happen." The reality, however, is that companies that have large capital needs require outside investment. Ownership in these companies must be shared by employees and investors. This discussion gave rise to the notion of "hybrid ownership" and the challenge for these companies to balance the interests of different shareholder groups.

1990

1990 was the year of participation. We were well beyond studying the theory and principles of employee ownership and were looking at implementation on a company-by-company basis. We were reviewing case studies that were teaching important lessons, which is a good exercise for any company considering this path. As John Simmons, President of Participation Associates, said, "Study successes and failures — but failures are much more informative."

A number of people told us about the need for employees to have some risk for employee ownership to have meaning. Employees have to put up money for ownership, or have some compensation or a portion of their net worth at risk, for the program to be meaningful.

Joe Blasi went on to describe what I believe is at the heart of an employee ownership culture. He said, "Employees want to have input at the job or department level," a truism in any work environment, but more importantly, that "people focus on the truth of information coming from management." And I agree with Blasi's further statement that "being honest is the first stage of worker participation."

1991

In 1991 we explored performance-based ownership methods.

We discussed whether performance or entitlement should be the criterion for stock ownership. I strongly believe that there should be a relationship between equity sharing and performance, as opposed to plans that distribute stock exclusively through retirement plans. You probably should do both, but ownership that is commensurate with contribution and performance should be a big component.

The second issue we tackled in 1991 I call the "problem" of wealth making. Bill Puchlevic of Amgen told us, "We have several hundred people who were nearly starving a few years ago who are now millionaires. If people have accumulated wealth, the minute work stops being fun could make a difference." My opinion on this is that some people are only in it for the money and there is nothing you can do about that. For others, if you can provide a challenging and interesting job — make work fun, as Puchlevic says — many people will care more about the company and the satisfaction their job gives them. Those are the ones who will stay.

The third concern in 1991 was whether employee participation leads to a loss of management control. But most employees don't want to be in charge, they just want to be included. They don't want to sit around all day making decisions, they want leadership that's based on communication."

1992

1992 was the year we focused on quality. Dr. Alan Carsrud, a professor at UCLA, saw employee ownership as a way of elevating the role of labor. He said, "Organizations focus too much on capital investments and too little on investments in people." That has particularly been true in the 1990s, as companies have been praised for downsizing and laying off tens of thousands of workers. "People, not machines, are our critical assets," said Carsrud. Equity sharing is a way of rewarding and retaining those assets.

Michele Hunt of Herman Miller talked about changing the corporate culture. Herman Miller has done away with its step-by-step product development process and adopted a more participatory work flow, with every department working on new ideas at the same time. "By becoming part of the product development process, people are having fun," she said. "If you don't believe in participation, I don't see how any quality programs are going to work."

We also discussed managing employee expectations. Some people expect a better deal than they would get in some other type of company. Many don't understand that an employee-owned company has to be like any other — it has to be competitive and serve its customers first. The success of the enterprise has to come before the benefits to the individual. Employee ownership does not mean utopia. It usually requires some sacrifice.

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1993

In 1993 we focused on communications. I've already said that employees are looking for leadership based on communication.

Owen Gaffney of Polaroid told us a story about the employee who was constantly interrupting and criticizing management at employee meetings. He finally lost his patience and asked the guy, "If you are so unhappy, why don't you leave?" The man said, "Because this is my company and the best company I've ever worked for. Tell me where else I can lay out what's wrong to a senior officer in front of 40 people and I'll consider leaving!" Companies who tackle employee ownership should be prepared for the two-way nature of this process. As someone said, be prepared to be humbled.

James Bixby, Chairman of Brooktree Corporation, said his company believes you translate employee ownership into entrepreneurship by encouraging sensible risk taking, which is one of the company's core values. "If you've got teams of people that are stepping up to bat and taking sensible risks, pat them on the back," he said. "Those are the kinds of people who are going to make the company very profitable."

In 1993 we also started to key in on the concept of equity sharing as part of the compensation system of "Tomorrows Corporation." That became the theme of the Aspen Seminars.

1994

In 1994 we focused on the issues of corporate governance in companies where equity is shared. An important issue in this context is dilution, as the company tries to find ways to add shareholders as it grows. Many companies are defensive about issuing new shares because it dilutes the holdings of present shareholders. The best view of dilution was presented by Joe Walkush in Aspen: If the value of the company's stock is increasing on a per-share basis in spite of issuing more shares, everyone is going to be better off. If you are achieving this goal, you shouldn't worry about share dilution.

We also discussed the role of the Board of Directors. The Board should not function in a vacuum, without employee contact. At the Aspen Seminar, Steve Greenberger of Avis said, "We can talk about corporate governance, we can talk about employees being on the Board, but it gets back to responsiveness and a participatory culture." We think employees should have a way of providing input to the board. This could be an employee member of the Board or someone who attends meetings as an observer. The method will depend on the company, but employee contact with the Board is essential.

Finally, in 1994 we began to realize that partnering with other organizations that have complementary missions can accelerate the progress of the Foundation. As a result, we have increased the work we do with groups such as CONNECT, the Stanford Center for International Security and Arms Control, the Kauffman Foundation, the Academy for Educational Development and the State University of New York.

1995 and Beyond

At this year's Aspen Seminar we continued to build on the theme of Tomorrow's Corporation. We discussed the fact that you need Board members who believe in the employee ownership concept. An employee-owned culture has risks, rewards and methods of organization and operation that Directors must accept, encourage and support. Employee ownership is not a short-term experiment the Board can easily reverse. This is a critical issue to consider when recruiting directors.

Some of our current discussion continues to revolve around the use of ESOPs. However, as I mentioned earlier, at SAIC we believe in the need to balance retirement plan stock distribution with direct incentive plans. We want to continue to look at ways for companies to do both.

Relating back to one of our original lessons learned in 1988, we continue to seek new methods to spread the word on employee ownership. I encourage greater use of the Internet for this because the Internet, with its unlimited international reach, is a unique vehicle for making learning about entrepreneurship and equity compensation exciting at all levels of society and in many other countries. The Foundation has put its publications on a World Wide Web site at which we are currently receiving 3,500 "requests" a week.

One final thought about the future of equity sharing and employee ownership and the role of the Foundation is that we have learned that you can't promote employee ownership in a vacuum. It must be tied to measurable, real-world issues. The Foundation bridges to many of these issues through its contacts with CONNECT, the Kauffman Foundation and the other groups I mentioned.

In the case of SAIC and many other companies, we relate ownership participation to successful entrepreneurship. Those who win new contracts, satisfy the customer and grow the business should receive a larger share of the pie.

The Foundation has become more active in helping Russian business people learn about how employee ownership can help them build a capitalistic economy.

We have increasingly been looking at how employee ownership of local businesses might change the outlook of people in the inner cities and give them motivation to improve their neighborhoods.

I'm sure there are other economic and social needs that can benefit from the application of these principles, such as building the high-performance company. You only need to review the proceedings of the conferences for the last eight years to realize this fact and to get more detailed information on the topics I've mentioned this morning.

Finally, the list before you of the types of employee ownership shows the complexity of the choices for companies. On the other hand, it shows there are many paths to the goal of equity sharing. At SAIC, we use them all.

The experience of the last eight years has convinced me that increased employee ownership will only come about through continued learning and continued effort. I'm sure many of the participants on today's program have thoughts on the future, and I look forward to learning the lessons of this conference.

Sometimes I feel the Foundation is trying to bite off too much or that our impact will be diluted. I also know there is more work to be done than the Foundation alone can do. At these times, I take comfort in the words of Margaret Mead, who wrote, "Never doubt that a small group of thoughtful, committed people can change the world. Indeed, it is the only thing that ever has." Today I still have the same faith and optimism we had in 1987. I've never doubted for a minute that this group, with a strong message and even stronger resolve, can change the world.